STERLING FINANCIAL CORP /WA/
Form 10-K
March 16, 2005

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ý ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the year ended December 31, 2004

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

COMMISSION FILE NUMBER 0-20800

STERLING FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Washington	**91-1572822**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

111 North Wall Street, Spokane, Washington 99201

(Address of principal executive offices) (Zip code)

Registrant s telephone number, including area code: **(509) 458-3711**

Securities registered pursuant to Section 12(b) of the Act:

None	**None**
(Title of each class)	(Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act:

Common Stock ($1.00 par value)

(Title of class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ý No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act).

Yes ý No o

As of June 30, 2004, the aggregate market value of the common equity held by non-affiliates of the registrant, computed by reference to the average of the bid and asked prices on such date as reported by The NASDAQ National Market, was $686,997,728.

The number of shares outstanding of the registrant s common stock, par value $1.00 per share, as of January 31, 2005 was 22,951,164.

DOCUMENTS INCORPORATED BY REFERENCE

Specific portions of the registrant s Proxy Statement dated March 25, 2005, are incorporated by reference into Part III hereof.

STERLING FINANCIAL CORPORATION

DECEMBER 31, 2004 ANNUAL REPORT ON FORM 10-K

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PART I

Item 1. Business

General

Sterling Financial Corporation (Sterling) is a unitary savings and loan holding company, the significant operating subsidiary of which is Sterling Savings Bank. The principal operating subsidiaries of Sterling Savings Bank are Action Mortgage Company (Action Mortgage), INTERVEST-Mortgage Investment Company (INTERVEST) and Harbor Financial Services, Inc. (Harbor Financial). Sterling Savings Bank commenced operations in 1983 as a Washington State-chartered, federally insured stock savings and loan association headquartered in Spokane, Washington.

Sterling provides personalized, quality financial services to its customers as exemplified by its Hometown Helpful® philosophy. Sterling believes that this dedication to personalized service has enabled it to grow both its retail deposit base and its lending portfolio in the Pacific Northwest region. With $6.94 billion in total assets at December 31, 2004, Sterling attracts Federal Deposit Insurance Corporation (the FDIC) insured deposits from the general public through 135 retail branches located in Washington, Oregon, Idaho and Montana. Sterling originates loans through its branch offices, as well as Action Mortgage residential loan production offices in the four-state area and through INTERVEST commercial real estate lending offices in Washington, Oregon, Arizona and California. Sterling also markets fixed income and equity products, mutual funds, fixed and variable annuities and many other financial products through Harbor Financial.

Sterling continues to enhance its presence as a leading community bank by increasing its commercial real estate, business banking, consumer and construction lending while also increasing its retail deposits, particularly transaction accounts. Commercial real estate, business banking, consumer and construction loans generally produce higher yields than residential loans. Management believes that a community bank mix of assets and liabilities will enhance its net interest income (NII) (the difference between the interest earned on loans and investments and the interest paid on deposits and borrowings) and will increase other fee income, although there can be no assurance in this regard. Such loans, however, generally involve a higher degree of risk than financing residential real estate. Sterling s revenues are derived primarily from interest earned on loans and asset-backed securities (ABS), fees and service charges, and mortgage banking operations. The operations of Sterling Savings Bank, and savings institutions generally, are influenced significantly by general economic conditions and by policies of its primary regulatory authorities, the Office of Thrift Supervision (OTS), the FDIC and the State of Washington Department of Financial Institutions (Washington Supervisor).

Company Growth

In January 2004, Sterling completed its acquisition of Klamath First Bancorp, Inc. (KFBI), in which KFBI was merged with and into Sterling, with Sterling being the surviving corporation, and KFBI s wholly owned subsidiary, Klamath First Federal Savings and Loan Association, was merged with and into Sterling s wholly owned subsidiary, Sterling Savings Bank, with Sterling Savings Bank being the surviving institution.

Under the terms of the KFBI acquisition, each share of KFBI common stock was converted into 0.77 shares of Sterling common stock. Sterling issued 5,431,067 shares of common stock in exchange for all of the stock of KFBI and assumed all outstanding KFBI options, which were converted into options to purchase 433,529 shares of Sterling s common stock. Sterling added approximately $988 million in deposits, $778 million in investments and ABS, $564 million in loans and $145 million in capital as a result of the KFBI acquisition, while adding approximately 450 employees to its work force. See Note 25 of Notes to Consolidated Financial Statements.

With this expanded branch network, Sterling has strengthened its position as a leading regional community bank. This acquisition is consistent with Sterling s strategy to become the leading community bank in the Pacific Northwest. KFBI s strong deposit base has complemented Sterling s asset growth strategy, while the combined branch network and access to capital have given Sterling the opportunity to continue its growth in the region.

In November 2004, INTERVEST acquired Peter W. Wong Associates, Inc. (PWWA), a commercial real estate lending entity, by merging PWWA with and into INTERVEST, with INTERVEST being the surviving entity in the merger. This acquisition expanded Sterling s capacity to originate commercial real estate loans and increased Sterling s commercial real estate servicing portfolio by $392.2 million. See Note 25 of Notes to Consolidated Financial Statements.

Sterling intends to continue to pursue an aggressive growth strategy to become the leading community bank in the Pacific Northwest. This strategy may include acquiring other financial businesses or branches thereof, or other substantial assets or deposit liabilities. Sterling may not be successful in identifying further acquisition candidates, integrating acquisitions or preventing such acquisitions from having an adverse effect on Sterling. There is significant competition for acquisitions in Sterling s market area, and Sterling may not be able to acquire other businesses on attractive terms. Furthermore, the success of Sterling s growth strategy will depend on increasing and maintaining sufficient levels of regulatory capital, obtaining necessary regulatory approvals, generating appropriate growth and the existence of favorable economic and market conditions. There can be no assurance that Sterling will be successful in implementing its growth strategy.

Profitability Drivers

We expect to increase our profitability in the future by:

continuing to change the mix of our loans to higher-yielding business banking, corporate banking and consumer loans.

growing our core deposits, particularly noninterest bearing consumer and commercial transaction deposits.

diversifying and growing our fee income through existing and new fee income sources, including deposit fees, fees from mortgage banking and other fees.

maintaining strong asset quality through robust underwriting and credit approval functions.

managing interest rate risk to protect net interest margin in a changing interest rate environment.

Together, we believe these strategies will contribute to increasing high quality earnings and maximizing shareholder value. The effect of these strategies on our financial results is discussed further in Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A).

Lending Activities

Focus on Community Lending. In recent years, Sterling has become more similar to a community bank by increasing its commercial real estate, business banking, consumer and construction lending. Commercial real estate, business banking, consumer and construction loans generally produce higher yields than residential permanent mortgage loans. Such loans, however, generally involve a higher degree of risk than financing residential real estate.

Business Lending. Sterling has structured its business lending in three groups: Business Banking, Corporate Banking and Private Banking. Sterling s Business Banking Group provides a full range of credit products to small- and medium-sized businesses and to individuals. Credit products include lines of credit, receivable and inventory financing, equipment loans, and permanent and construction real restate financing. Loans may be made unsecured, partially secured or fully secured based on certain credit criteria. The credit product line for both businesses and individuals includes standardized products, as well as customized accommodations.

Sterling s Corporate Banking Group provides a full line of financial services to middle market companies in its service area. Credit products include lines of credit, receivable and inventory financing, equipment loans and permanent and construction financing. Loans may be made on an unsecured, partially secured or fully secured basis. The Corporate Banking Group also serves the needs of the owners and key employees of its business customers.

Sterling s Private Banking Group provides services to higher-net-worth and higher-income borrowers by originating a variety of consumer and business banking loans. Such loans generally, but do not always, meet the same underwriting requirements or have the same terms as general consumer loans of the same type.

Sterling has established minimum underwriting standards, which delineate criteria for sources of repayment, financial strength and credit enhancements such as guarantees. Typically, the primary source of repayment is recurring cash flow of the borrower or cash flow from the business or project being financed. Depending on the type of loan, underwriting standards include minimum financial requirements, maximum loan-to-collateral value ratios, minimum cash flow coverage of debt service, debt-to-income ratios and minimum liquidity requirements. Exceptions to the minimum underwriting standards may be made depending upon the type of loan and financial strength of the borrower. Exceptions are reported to the appropriate level of authority up to and including the board of directors. Common forms of collateral pledged to secure business banking loans include real estate, accounts receivable, inventory, equipment, agricultural crops or livestock and marketable securities. Most loans have maximum terms of one to ten years and loan-to-value ratios in the range of 65% to 80%, based on an analysis of the collateral pledged.

Business, private and corporate banking loans generally involve a higher degree of risk than financing real estate, primarily because collateral is more difficult to appraise, the collateral may be difficult to obtain or liquidate following an uncured default and it is difficult to accurately predict the borrower s ability to generate future cash flows. These loans, however, typically offer relatively higher yields and variable interest rates. The availability of such loans enables potential depositors to establish full-service banking relationships with Sterling.

***Multifamily Residential and Commercial Real Estate Lending*.** Sterling offers multifamily residential and commercial real estate loans as both construction and permanent loans collateralized by real property. Although Sterling s market for such loans is primarily in the Pacific Northwest, Sterling has production offices in Phoenix, Arizona and Sacramento, California. Construction loans on such properties typically have terms of 12 to 24 months and have variable interest rates. Permanent fixed- and adjustable-rate loans on existing properties typically have maturities of three to ten years. Multifamily residential and commercial real estate loans generally involve a higher degree of risk than one- to four-family residential real estate loans, because they typically involve large loan balances to single borrowers or groups of related borrowers. The payment experience on such loans typically is dependent on the successful operation of the real estate project and is subject to certain risks not present in one- to four-family residential mortgage lending. These risks include excessive vacancy rates or inadequate operating cash flows. Construction lending is subject to risks such as construction delays, cost overruns, insufficient values and an inability to obtain permanent financing in a timely manner. Sterling attempts to reduce its exposure to these risks by limiting loan amounts to the amounts readily accepted in the secondary market, by closely monitoring the construction disbursement process, by investigating the borrowers finances and, depending on the circumstances, requiring annual financial statements from the borrowers, requiring operating statements on the properties or acquiring personal guarantees from the borrowers.

***One- to Four-Family Residential Lending*.** Sterling originates fixed- and adjustable-rate residential mortgages (ARMs), which have interest rates that adjust annually or every three, five or seven years and are indexed to a variety of market indices.

Sterling continues to originate conventional and government-insured residential loans for sale into the secondary mortgage market. Within the secondary mortgage market for conventional loans, Sterling sells its residential loans both on a servicing-released and servicing-retained basis. Sterling also sells loans to the Federal Home Loan Mortgage Corporation (FHLMC), the Federal Home Loan Bank (FHLB Seattle) and the Federal National Mortgage Association (FNMA). Sterling endeavors to underwrite residential loans in compliance with these agencies underwriting standards. Loans sold into the secondary market are all sold without recourse to Sterling, except that Sterling may be obligated to repurchase any loans that are not underwritten in accordance with these agencies or applicable investor underwriting guidelines.

Conventional residential mortgage loans are originated for up to 103% of the appraised value or selling price of the mortgaged property, whichever is less. Borrowers must purchase private mortgage insurance from approved third parties so that Sterling s risk is limited to approximately 80% of the appraised value on all loans with loan-to-value ratios in excess of 80%. Sterling s residential lending programs are designed to comply with all applicable regulatory requirements. For a discussion of Sterling s management of interest rate risk (IRR) on conventional loans, see *Secondary Market Activities.*

Sterling originates residential construction loans on custom homes, presold homes and spec homes. Sterling also provides acquisition and development loans for residential subdivisions. Construction financing is generally considered to involve a higher degree of risk than long-term financing on improved, occupied real estate. Sterling s risk of loss on construction loans depends largely upon the accuracy of the initial estimate of the property s value at completion of construction or development and the estimated cost (including interest) of construction. If the estimate of construction costs proves to be inaccurate, Sterling might have to advance funds beyond the amount originally committed to permit completion of the development and to protect its security position. Sterling also might be confronted, at or prior to maturity of the loan, with a project with insufficient value to ensure full repayment. Sterling s underwriting, monitoring and disbursement practices with respect to construction financing are intended to ensure that sufficient funds are available to complete construction projects. Sterling endeavors to limit its risk through its underwriting procedures by using only approved, qualified appraisers and by dealing only with qualified builders/borrowers. The properties that serve as underlying collateral for these construction loans are located primarily in the states of Washington, Oregon, Idaho and Montana.

As of December 31, 2004, approximately 39% of Sterling s one- to four-family residential construction loans consisted of loans for spec properties. Further, as of December 31, 2004, approximately 33% and 24% of Sterling s one- to four-family residential construction loan portfolio is concentrated in the greater Portland, Oregon and Seattle, Washington markets, respectively. A reduction in market value or in demand for residential housing, particularly in the aforementioned markets, could lead to higher delinquencies and foreclosures and have a negative impact on Sterling.

Consumer Lending. Consumer loans and lines of credit are originated directly through Sterling s retail branches and Private Banking Group, and indirectly through Sterling s Dealer Banking Department. Sterling finances purchases of consumer goods including automobiles, boats and recreational vehicles, and lines of credit for personal use. Generally, consumer loans are originated for terms ranging from six months to ten years. Interest rates may be either fixed or adjustable based on a contractual formula tied to established external indices. Sterling also makes loans secured by borrowers savings accounts and equity loans collateralized by residential real estate. Equity loans may have maturities of up to 15 years.

The following table sets forth information on loan originations for the periods indicated:

	Years Ended December 31, 2004 Amount	2004 %	2003 Amount (Dollars in thousands)	2003 %	2002 Amount	2002 %
Mortgage - permanent:						
One- to four-family residential	$ 400,391	13.7	$ 504,169	22.2	$ 350,973	19.2
Multifamily residential	43,395	1.5	71,962	3.2	77,761	4.3
Commercial real estate	241,754	8.3	114,487	5.0	66,492	3.6
	685,540	23.5	690,618	30.4	495,226	27.1
Mortgage - construction:						
One- to four-family residential	719,146	24.6	531,875	23.4	481,328	26.3
Multifamily residential	102,970	3.5	79,463	3.5	62,498	3.4
Commercial property	203,401	7.0	96,213	4.2	54,621	3.0
	1,025,517	35.1	707,551	31.1	598,447	32.7
Total mortgage loans	1,711,057	58.6	1,398,169	61.5	1,093,673	59.8
Commercial and consumer:						
Corporate banking	352,767	12.1	204,733	9.0	121,348	6.6
Business banking	465,827	16.0	386,521	17.0	403,181	22.1
Consumer - direct	332,076	11.4	211,505	9.3	146,575	8.0
Consumer - indirect	56,403	1.9	73,046	3.2	64,333	3.5

Total commercial and consumer loans		1,207,073	41.4		875,805	38.5		735,437	40.2
Total loans originated	$	2,918,130	100.0	$	2,273,974	100.0	$	1,829,110	100.0

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Loan Portfolio Analysis. The following table sets forth the composition of Sterling s loan portfolio by type of loan at the dates indicated:

	December 31, 2004 Amount	%	2003 Amount	%	2002 Amount	%	2001 Amount	%	2000 Amount	%
	(Dollars in thousands)									
Mortgage - permanent:										
One- to four-family residential	$ 794,632	18.4	$ 407,999	13.8	$ 358,359	14.8	$ 315,242	14.8	$ 409,592	20.6
Multifamily residential	184,754	4.3	167,220	5.7	161,547	6.7	155,250	7.3	163,675	8.2
Commercial real estate	699,879	16.3	463,191	15.7	458,712	18.9	438,594	20.5	347,654	17.5
Land and other	0	0.0	0	0.0	0	0.0	925	0.0	956	0.0
	1,679,265	39.0	1,038,410	35.2	978,618	40.4	910,011	42.6	921,877	46.3
Mortgage - construction:										
One- to four-family residential	356,644	8.3	271,480	9.2	280,514	11.6	214,849	10.1	215,844	10.9
Multifamily residential	102,166	2.4	127,424	4.3	96,297	4.0	88,977	4.2	80,728	4.1
Commercial real estate	194,085	4.5	154,061	5.2	104,108	4.3	92,089	4.3	81,347	4.1
	652,895	15.2	552,965	18.7	480,919	19.9	395,915	18.6	377,919	19.1
Total mortgage loans	2,332,160	54.2	1,591,375	53.9	1,459,537	60.3	1,305,926	61.2	1,299,796	65.4
Commercial and consumer:										
Business, private and corporate banking	1,311,197	30.4	948,304	32.2	655,727	27.0	520,866	24.3	435,284	21.9
Consumer - direct	543,895	12.6	309,931	10.5	246,578	10.2	244,097	11.4	235,423	11.8
Consumer - indirect	120,894	2.8	99,697	3.4	62,896	2.5	65,169	3.1	17,682	0.9
Total commercial and consumer loans	1,975,986	45.8	1,357,932	46.1	965,201	39.7	830,132	38.8	688,389	34.6
Total loans receivable	4,308,146	100.0	2,949,307	100.0	2,424,738	100.0	2,136,058	100.0	1,988,185	100.0
Deferred loan origination fees, net of costs	(6,907)		(7,276)		(6,450)		(5,980)		(5,518)	
Gross loans receivable	4,301,239		2,942,031		2,418,288		2,130,078		1,982,667	
	(49,362)		(35,605)		(27,866)		(20,599)		(16,740)	

Allowance for loan losses					
Loans receivable, net	$ 4,251,877	$ 2,906,426	$ 2,390,422	$ 2,109,479	$ 1,965,927

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Contractual Principal Payments. The following table sets forth the scheduled contractual principal repayments for Sterling s loan portfolio at December 31, 2004. Demand loans, loans having no stated repayment schedule and no stated maturity, and overdrafts are reported as due in one year or less. Loan balances do not include undisbursed loan proceeds, deferred loan origination costs and fees, or allowances for loan losses.

	Balance Outstanding at December 31, 2004	Principal Payments Contractually Due in Fiscal Years 2005	2006-2009	Thereafter
		(Dollars in thousands)		
Mortgage - permanent:				
Fixed rate	$ 730,998	$ 24,981	$ 131,812	$ 574,205
Variable rate	948,267	64,414	317,111	566,742
Mortgage - construction	652,895	374,264	237,525	41,106
Consumer - direct	543,894	216,791	99,964	227,139
Consumer - indirect	120,895	25,422	87,702	7,771
Business, private and corporate banking	1,311,197	672,563	322,789	315,845
	$ 4,308,146	$ 1,378,435	$ 1,196,903	$ 1,732,808

Loan Servicing. Sterling services its own loans, as well as loans owned by others. Loan servicing includes collecting and remitting loan payments, accounting for principal and interest, holding escrow funds for the payment of real estate taxes and insurance premiums, contacting delinquent borrowers and supervising foreclosures in the event of unremedied defaults. For loans serviced by others, Sterling generally receives a fee based on the unpaid principal balance of each loan to compensate for the costs of performing the servicing function.

For residential mortgage loans serviced for other investors, Sterling receives a fee, generally ranging from 24 to 37 basis points of the unpaid principal balance. At December 31, 2004 and 2003, Sterling serviced for itself and for other investors, residential mortgage loans totaling $1.17 billion and $737.6 million, respectively. Of such mortgage loans, Sterling serviced $373.6 million and $329.4 million, respectively, at these dates for FHLMC, FHLB and FNMA. Sterling s ability to continue as a seller/servicer for these agencies is dependent upon meeting their qualifications. Sterling currently meets all applicable requirements. In November 2004, INTERVEST acquired PWWA, expanding Sterling s commercial real estate servicing portfolio by $392.2 million.

Sterling receives a fee for servicing commercial and multifamily real estate loans for other investors. This fee generally ranges from 5 to 25 basis points of the unpaid principal balance. At December 31, 2004 and 2003, Sterling serviced for itself and other investors, commercial and multifamily real estate loans totaling $1.48 billion and $842.0 million, respectively.

Sterling also receives a fee of 50 basis points of the unpaid principal balance of each loan for servicing automobile loans for other investors. At December 31, 2004 and 2003, Sterling serviced $7.8 million and $25.9 million of such loans, respectively.

Secondary Market Activities. Sterling has developed correspondent relationships with a number of mortgage companies and financial institutions to facilitate the origination or purchase and sale of mortgage loans in the secondary market on either a participation or whole loan basis. Substantially all of such purchased loans or participations are secured by real estate. Those agents who present loans to Sterling for purchase are required to provide a processed loan package prior to commitment. Sterling then underwrites the loan in accordance with its established lending standards.

Sterling, from time to time, sells participations in certain commercial real estate loans to investors on a servicing-retained basis. During the years ended December 31, 2004 and 2003, Sterling sold approximately $16.3 million and $35.9 million in loans under participation agreements, resulting in net gains of $44,000 and $328,000, respectively.

Sterling generally receives a fee of approximately 100 to 200 basis points of the principal balance of mortgage loans for releasing the servicing. In 2004, 64% of Sterling s sales of Federal Housing Administration (FHA) and Department of Veterans Affairs (VA) insured loans were sold into the secondary market on a loan-by-loan, servicing-released basis, compared with 41% in 2003.

In 2004, 36% of Sterling s sales of conventional, FHA and VA insured loans were sold into the secondary market on a servicing-retained basis, compared with 59% in 2003. Sterling records a valuation of approximately 100 to 115 basis points of the principal balance of such loans for retaining the servicing. At December 31, 2004 and 2003, Sterling had recorded as net assets $4.1 million and $3.5 million in servicing rights, respectively. See Note 3 of Notes to Consolidated Financial Statements.

Loan Commitments. Sterling makes written commitments to individual borrowers and mortgage brokers for the purposes of originating and purchasing loans. These loan commitments establish the terms and conditions under which Sterling will fund the loans. Sterling had outstanding commitments to originate or purchase loans, the undisbursed portion of which aggregated $485.2 million and $279.0 million at December 31, 2004 and 2003, respectively. Sterling also had secured and unsecured commercial and personal lines of credit, the undisbursed portion of which was approximately $623.1 million and $370.8 million at December 31, 2004 and 2003, respectively. See Note 17 of Notes to Consolidated Financial Statements.

Derivatives and Hedging. Sterling, through its subsidiary Action Mortgage, enters into interest rate lock commitments to prospective residential mortgage borrowers. Action Mortgage hedges IRR by entering into nonbinding (best-efforts) forward sales agreements with third parties. In addition, to improve and protect the profit margin on loans sold into the secondary market, Action Mortgage hedges IRR by entering into binding (mandatory) forward sales agreements on ABS with third parties.

The risks inherent in such mandatory forward sales agreements include the risk that, if for any reason Action Mortgage does not close and sell the loans in question, it is nonetheless obligated to deliver ABS to the counterparty on the agreed terms. Action Mortgage could incur significant costs in acquiring replacement loans or ABS and such costs could have a material adverse impact on mortgage banking operations in future periods, especially in rising interest rate environments. During the years ended December 31, 2004 and 2003, Sterling recorded $231,000 and $1.1 million in revenue from forward sales agreements and similar transactions, respectively. This revenue is a component of income from mortgage banking operations in the income statement.

Rate lock commitments and forward sales agreements are considered to be derivatives. Sterling has recorded the estimated fair values of the rate lock commitments and forward sales agreements on its balance sheet in either other assets or other liabilities. Changes in the fair values of these derivative instruments are recorded in income from mortgage banking operations in the income statement as the changes occur. The estimated fair value of rate lock commitments and forward sales agreements were greater than the contracted amounts, which resulted in assets of $76,000 and $12,000, respectively, at December 31, 2004. Rate lock commitments and forward sales agreements were a liability of $84,000 and an asset of $73,000, respectively, at December 31, 2003.

Classified Assets, Real Estate Owned and Delinquent Loans. To measure the quality of assets, including loans and real estate owned (REO), Sterling has established guidelines for classifying assets and determining provisions for anticipated loan and REO losses. Under these guidelines, an allowance for anticipated loan and REO losses is established when certain conditions exist. This system for classifying and reserving for loans and REO is administered by Sterling s Special Assets Department, which is responsible for minimizing loan deficiencies and losses therefrom. An oversight committee, comprised of senior management, monitors the activities of the Special Assets Department and reports results to Sterling s Board of Directors.

Under this system, Sterling classifies loans and other assets it considers of questionable quality. Sterling s system employs the classification categories of substandard, doubtful and loss. Substandard assets have deficiencies, which give rise to the distinct possibility that Sterling will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets, and on the basis of currently existing facts, there is a high probability of loss. An asset classified as loss is considered uncollectible and of such little value that it should not be included as an asset of Sterling. Total classified assets decreased to $68.3 million at December 31, 2004, from $84.8 million at December 31, 2003. As a percentage of total assets, classified assets decreased from the prior year. The percentage of classified assets to total assets was 0.98% and 1.98% at December 31, 2004 and 2003, respectively. See *Major Classified Loans.*

Assets classified as substandard or doubtful require the establishment of valuation allowances in amounts considered by management to be adequate under accounting principles generally accepted in the United States of America (GAAP). Assets classified as loss require either a specific valuation allowance of 100% of the amount classified or a write-off of such amount. At December 31, 2004, Sterling s assets classified as loss totaled $3.6 million compared to $3.3 million at December 31, 2003. Judgments regarding the adequacy of a valuation allowance are based on ongoing evaluations of the nature, volume and quality of the loan portfolio, REO and other assets, specific problem assets and current economic conditions that may affect the recoverability of recorded amounts.

REO is recorded at the lower of estimated fair value, less estimated selling expenses, or carrying value at foreclosure. Fair value is defined as the amount in cash or other consideration that a real estate asset would yield in a current sale between a willing buyer and a willing seller. Development and improvement costs relating to the property are capitalized to the extent they are deemed to be recoverable upon disposal. The carrying value of REO is continuously evaluated and, if necessary, an allowance is established to reduce the carrying value to net realizable value, which considers, among other things, estimated direct holding costs and selling expenses.

The following table sets forth the activity in Sterling s REO for the periods indicated:

	Years Ended December 31, 2004	2003 (Dollars in thousands)	2002
Balance at beginning of period	$ 4,226	$ 3,953	$ 2,982
Loan foreclosures and other additions	4,445	3,900	7,876
Improvements and other changes	(132)	282	715
Sales	(6,669)	(3,729)	(7,382)
Provisions for losses	(5)	(180)	(238)
Balance at end of period	$ 1,865	$ 4,226	$ 3,953

Major Classified Loans. Sterling s classified loans, with a net carrying value at December 31, 2004 of more than $4.0 million each, which together constitute 34.2% of classified assets, included the following:

Sterling holds an income property loan secured by a specialized care facility located in Arizona. The aggregate carrying value of this loan at December 31, 2004, was $8.1 million. This loan remains current as to interest, and the term has been extended through the end of March 2005.

Sterling holds two income property construction loans and a commercial line of credit secured by a hotel in western Washington. The aggregate carrying value of these loans at December 31, 2004 was $5.7 million. Borrowers are performing under the terms of a conditional forbearance agreement, and negotiations regarding a revised forbearance agreement are in progress.

Sterling holds an income property loan secured by a specialized care facility located in western Washington. The aggregate carrying value of this loan at December 31, 2004 was $5.2 million. The loan has been classified due to the facility s low occupancy rates, but continues to perform as agreed and is being closely monitored.

Sterling holds an income property loan secured by four hotel properties located in the Pacific Northwest. The aggregate carrying value of this loan at December 31, 2004 was $4.3 million. Sterling believes potential losses are reserved sufficiently. These hotels are operating under receivership, and the receiver continues to actively market the properties with prospective buyers.

Major Real Estate Owned. At December 31, 2004, the aggregate value of outstanding REO properties was $1.9 million. None of the REO properties had a carrying value of more than $1.0 million.

Delinquent Loan Procedures. Delinquent and problem loans are part of any lending business. If a borrower fails to make a required payment when due, Sterling institutes internal collection procedures. For residential mortgage and consumer loans, Sterling s collection procedures generally require that an initial request for payment be mailed to the borrower when the loan is 15 days past due. At 25 days past due, the borrower is contacted by telephone and payment is requested orally. At 30 days past due, Sterling records the loan as a delinquency. In the case of delinquent residential mortgage loans, a notice of intent to foreclose is mailed at 45 days past due. If the loan is still delinquent 30 days following the mailing of the notice of intent to foreclose, Sterling generally initiates foreclosure proceedings.

For consumer loans, a demand letter is sent when the account becomes delinquent for two payments. Additional collection work or repossession may follow. In certain instances, Sterling may modify the loan or grant a limited moratorium on loan payments to enable the borrower to reorganize his or her financial affairs. Collection procedures similar to those used for consumer and residential mortgage loans are followed for commercial, construction and income property loans, with the exception that these accounts are generally handled as a joint effort between the originating loan officer and the Special Assets Department during initial stages of delinquency. On or before 60 days of delinquency, the collection effort is typically shifted from the originating loan officer to the Special Assets Department.

The following table summarizes the principal balances of nonperforming assets at the dates indicated:

	December 31, 2004	2003	2002	2001	2000
	(Dollars in thousands)				
Nonaccrual loans	$ 10,738	$ 16,208	$ 16,278	$ 21,102	$ 8,385
Restructured loans	1,305	1,164	594	886	0
Total nonperforming loans	12,043	17,372	16,872	21,988	8,385
Real estate owned (1)	1,865	4,226	3,953	2,982	6,407
Total nonperforming assets	$ 13,908	$ 21,598	$ 20,825	$ 24,970	$ 14,792
Ratio of total nonperforming assets to total assets	0.20%	0.50%	0.59%	0.82%	0.56%
Ratio of total nonperforming loans to gross loans	0.28%	0.59%	0.70%	1.03%	0.42%
Ratio of allowance for estimated losses on loans to total nonperforming loans (2)	538.3%	216.6%	174.3%	91.9%	190.1%

(1) Amount is net of the allowance for REO losses.

(2) Excludes loans classified as loss. Loans classified as loss that are excluded from allowance for loan losses were $3,528,000, $2,897,000, $2,067,000, $1,843,000 and $803,000 at December 31, 2004, 2003, 2002, 2001 and 2000, respectively. There were no loans classified as loss that are excluded from total nonperforming loans in any of the periods.

Sterling regularly reviews the collectibility of accrued interest and generally ceases to accrue interest on a loan when either principal or interest is past due by 90 days or more. Any accrued and uncollected interest is reversed from income at that time. Loans may be placed in nonaccrual status earlier if, in management s judgment, the loan may be uncollectible. Interest on such a loan is then recognized as income only if collected or if the loan is restored to performing status. Interest income of $659,000, $1,025,000 and $1,103,000 was recorded on these loans during the years ended December 31, 2004, 2003 and 2002, respectively. Additional interest income of $1,348,000, $1,487,000 and $778,000 would have been recorded during the years ended December 31, 2004, 2003 and 2002, respectively, if nonaccrual and restructured loans had been current in accordance with their original contractual terms.

Allowance for Loan and Real Estate Owned Losses. Generally, Sterling establishes specific allowances for the difference between the anticipated fair value (market value less selling costs, foreclosure costs and projected holding costs), adjusted for other possible sources of repayment, and the book balance (loan principal and accrued interest or carrying value of REO) of its loans classified as loss and REO. Each classified loan and REO property is reviewed at least monthly. Allowances are established or periodically adjusted, if necessary, based on the review of information obtained through on-site inspections, market analysis, appraisals and purchase offers.

The allowance for loan losses is maintained at a level deemed appropriate by management to adequately provide for known and probable losses and inherent risks in the loan portfolio. The allowance is based upon a number of factors, including prevailing and anticipated economic trends, industry experience, estimated collateral values, management s assessment of credit risk inherent in the portfolio, delinquency trends, historical loss experience, specific problem loans and other relevant factors.

Additions to the allowance, in the form of provisions, are reflected in current operating results, while charge-offs to the allowance are made when a loss is determined to have occurred. Because the allowance for loan losses is based on estimates, ultimate losses may materially differ from the estimates. See Note 5 of Notes to Consolidated Financial Statements.

Management believes that the allowance for loan losses is adequate given the composition and risks of the loan portfolios, although there can be no assurance that the allowance will be adequate to cover all contingencies. The following table sets forth information regarding changes in Sterling s allowance for estimated losses on loans for the periods indicated:

	Years Ended December 31,				
	2004	2003	2002	2001	2000
	(Dollars in thousands)				
Balance at beginning of period	$ 35,605	$ 27,866	$ 20,599	$ 16,740	$ 15,603
Charge-offs:					
Mortgage - permanent	(59)	(165)	(48)	(270)	(209)
Mortgage - construction	(645)	(106)	(868)	(756)	(618)
Consumer - direct	(1,373)	(1,146)	(954)	(1,011)	(1,181)
Consumer - indirect	(370)	(445)	(407)	(544)	(1,048)
Business, private and corporate banking	(3,036)	(2,391)	(2,776)	(2,016)	(835)
Total charge-offs	(5,483)	(4,253)	(5,053)	(4,597)	(3,891)
Recoveries:					
Mortgage - permanent	25	42	19	9	27
Mortgage - construction	2	3	2	31	1
Consumer - direct	214	160	208	203	165
Consumer - indirect	111	149	170	184	209
Business, private and corporate banking	16	268	54	29	26
Total recoveries	368	622	453	456	428
Net charge-offs	(5,115)	(3,631)	(4,600)	(4,141)	(3,463)
Provisions for loan losses	12,150	10,500	11,867	8,000	4,600
Allowance for losses on assets acquired	6,722	870	0	0	0
Balance at end of period	$ 49,362	$ 35,605	$ 27,866	$ 20,599	$ 16,740
Allowances allocated to loans classified as loss	$ 3,528	$ 2,897	$ 2,067	$ 1,843	$ 803
Ratio of net charge-offs to average loans outstanding during the period	0.13%	0.13%	0.21%	0.21%	0.18%

Allowances are provided for individual loans when management considers ultimate collection to be questionable. Such allowances are based, among other factors, upon the estimated net realizable value of the collateral of the loan or guarantees, if applicable. The following table sets forth the allowances for estimated losses on loans by category and summarizes the percentage of total loans in each category to total loans:

	December 31, 2004		2003		2002		2001		2000	
	Allowance Amount	Loans in Category as a Percentage of Total Loans	Allowance Amount	Loans in Category as a Percentage of Total Loans	Allowance Amount	Loans in Category as a Percentage of Total Loans	Allowance Amount	Loans in Category as a Percentage of Total Loans	Allowance Amount	Loans in Category as a Percentage of Total Loans
	(Dollars in thousands)									
Mortgage - permanent	$ 10,632	39.0	$ 4,902	35.2	$ 2,881	40.4	$ 2,285	42.6	$ 3,801	46.3
Mortgage - construction	6,264	15.2	6,336	18.7	6,199	19.9	3,601	18.6	3,903	19.1
Consumer - direct	7,247	12.6	3,843	10.5	2,986	10.2	2,812	11.4	2,907	11.8
Consumer - indirect	1,156	2.8	1,676	3.4	1,349	2.5	1,202	3.1	760	0.9
Business, private and corporate banking	23,710	30.4	17,979	32.2	14,014	27.0	10,211	24.3	5,166	21.9
Unallocated	353	N/A	869	N/A	437	N/A	488	N/A	203	N/A
	$ 49,362	100.0	$ 35,605	100.0	$ 27,866	100.0	$ 20,599	100.0	$ 16,740	100.0

Investments and Asset-Backed Securities

Investments and ABS that management has the positive intent and ability to hold to maturity are classified as held to maturity and carried at amortized cost. At December 31, 2004 and 2003, investments and ABS classified as held to maturity were $47.4 million and $2.2 million, respectively. See MD&A Critical Accounting Policies *Investments and ABS*.

At December 31, 2004 and 2003, investments and ABS classified as available for sale were $2.16 billion and $1.07 billion, respectively. The carrying value of these investments and ABS at December 31, 2004 and 2003 includes net unrealized losses of $14.8 million and $23.4 million, respectively. Fluctuations in prevailing interest rates continue to cause volatility in this component of accumulated comprehensive income and may continue to do so in future periods. See MD&A Critical Accounting Policies *Investments and ABS*.

Sterling invests primarily in ABS issued by FHLMC and FNMA and other agency obligations. Such investments provide Sterling with a relatively liquid source of interest income and collateral, which can be used to secure borrowings. Sterling invests primarily in investment-grade investments and ABS. See MD&A Results of Operations *Other Income/Expense* and Note 1 of Notes to Consolidated Financial Statements.

The following table provides the carrying values, contractual maturities and weighted average yields of Sterling s investment and ABS portfolio at December 31, 2004. Actual maturities may differ from the contractual maturities, because issuers may have the right to call or prepay obligations with or without prepayment penalties.

	Less than One Year	**One to Five Years**	**Maturity Over Five to Ten Years (Dollars in thousands)**	**Over Ten Years**	**Total**
Asset-backed securities					
Balance	$ 0	$ 0	$ 172,074	$ 1,864,846	$ 2,036,920
Weighted average yield	0.00%	0.00%	4.14%	4.67%	4.62%
U.S. government and agency obligations					
Balance	$ 5,007	$ 23,063	$ 0	$ 0	$ 28,070
Weighted average yield	2.77%	2.95%	0.00%	0.00%	2.87%
FHLB Seattle stock, at cost					
Balance	$ 0	$ 0	$ 0	$ 74,846	$ 74,846
Weighted average yield (1)	0.00%	0.00%	0.00%	2.66%	2.66%
Municipal bonds					
Balance	$ 326	$ 2,642	$ 4,507	$ 39,974	$ 47,449
Weighted average yield (2)	4.89%	3.90%	3.44%	4.50%	4.37%
Other (3)					
Balance	$ 715	$ 80	$ 0	$ 16,505	$ 17,300
Weighted average yield	1.83%	3.20%	0.00%	0.00%	0.09%
Total carrying value	$ 6,048	$ 25,785	$ 176,581	$ 1,996,171	$ 2,204,585
Weighted average yield	2.77%	3.05%	4.12%	4.56%	4.50%

(1) The weighted average yield on FHLB Seattle stock is based upon the dividends received for the year ended December 31, 2004. Sterling expects the dividends in 2005 to be substantially lower than those in 2004.

(2) The weighted average yields on municipal bonds reflect the actual yields on the bonds and are not presented on a tax-equivalent basis.

(3) Other investments relate primarily to limited partnership interests in low-income housing projects.

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The following table sets forth the carrying values and classifications for financial statement reporting purposes of Sterling s investment and ABS portfolio at the dates indicated:

	December 31, 2004	2003	2002
	(Dollars in thousands)		
Asset-backed securities	$ 2,036,920	$ 983,736	$ 743,610
U.S. government and agency obligations	28,070	13,333	13,666
FHLB Seattle stock	74,846	51,261	42,213
Municipal bonds	47,449	6,285	3,352
Other	17,300	18,569	27,327
Total	$ 2,204,585	$ 1,073,184	$ 830,168
Available for sale	2,157,136	1,070,955	826,692
Held to maturity	47,449	2,229	3,476
Total	$ 2,204,585	$ 1,073,184	$ 830,168
Weighted average yield	4.50%	4.62%	4.65%

Sources of Funds

General. Sterling s primary sources of funds for use in lending and for other general business purposes are deposits, loan repayments, FHLB Seattle advances, secured lines of credit and other borrowings, proceeds from sales of investments and ABS, and proceeds from sales of loans. Scheduled loan repayments are a relatively stable source of funds, while other sources of funds are influenced significantly by prevailing interest rates, interest rates available on other borrowings and other economic conditions. Borrowings also may be used on a short-term basis to compensate for reductions in other sources of funds (such as deposit inflows at less than projected levels). Borrowings may also be used on a longer-term basis to support expanded lending activities and to match repricing intervals of assets. See Lending Activities and Investments and Asset-Backed Securities.

Deposit Activities. As a regional community bank, Sterling offers a variety of accounts for depositors designed to attract both short-term and long-term deposits from the general public. These accounts include money market deposit accounts (MMDA) and checking accounts, in addition to more traditional savings accounts and certificates of deposit (CDs) accounts. Sterling offers both interest- and noninterest-bearing checking accounts. The interest-bearing checking accounts can be subject to monthly service charges, unless a minimum balance is maintained. MMDA, CDs and savings accounts earn interest at rates established by management and are based on a competitive market analysis. The method of compounding varies from simple interest credited at maturity to daily compounding, depending on the type of account.

With the exception of certain promotional CDs and variable-rate 18-month Individual Retirement Account certificates, all CDs carry a fixed rate of interest for a defined term from the opening date of the account. Substantial penalties are imposed if principal is withdrawn from most CDs prior to maturity.

Sterling supplements its retail deposit gathering by soliciting funds from public entities and acquiring brokered deposits. Public funds were 8.5% and 13.9% of deposits at December 31, 2004 and 2003, respectively. Public funds are generally obtained by competitive bidding among qualifying financial institutions. Sterling had $375.3 million and $114.2 million of brokered deposits at December 31, 2004 and 2003, respectively.

The primary deposit vehicles being utilized by Sterling s customers are CDs with terms of one year or less, regular savings accounts, MMDA, commercial checking, or noninterest-bearing demand accounts and negotiable order of withdrawal (NOW) accounts. The following table presents the average balance outstanding and weighted average interest rate paid for each major category of deposits for the periods indicated:

	Years Ended December 31,					
	2004		2003		2002	
	Average Balance	Weighted Average Interest Rate	Average Balance	Weighted Average Interest Rate	Average Balance	Weighted Average Interest Rate
	(Dollars in thousands)					
Time deposits	$ 1,608,599	2.57%	$ 1,152,281	2.54%	$ 1,052,792	3.44%
Regular savings and MMDA	1,092,612	1.04	572,842	1.15	364,823	1.62
Checking accounts:						
NOW checking accounts	399,963	0.21	318,722	0.31	335,003	0.44
Noninterest-bearing demand accounts	546,128	0.00	280,990	0.00	206,323	0.00
	$ 3,647,302	1.47%	$ 2,324,835	1.58%	$ 1,958,941	2.23%

The following table shows the amounts and remaining maturities of time deposits that had balances of $100,000 or more at December 31, 2004 and 2003:

	December 31,	
	2004	2003
	(Dollars in thousands)	
Less than three months	$ 293,748	$ 296,458
Three to six months	245,928	113,516
Six to twelve months	202,773	164,436
Over twelve months	261,189	87,859
	$ 1,003,638	$ 662,269

The following table presents the types of deposit accounts and the rates offered by Sterling Savings Bank and the balances in such accounts as of the specified dates:

		December 31, 2004				December 31, 2003			
Minimum Term	Category	Minimum Balances	Amount	Percentage of Total Deposits	Interest Rate Offered	Minimum Balances	Amount	Percentage of Total Deposits	Interest Rate Offered
		(Dollars in thousands, except minimum amounts)							
Transaction Accounts:									
None	NOW checking	Varies	$ 413,217	10.7	0.10%	Varies	$ 301,197	12.3	0.10%
None	Commercial checking	Varies	574,186	14.9	0.00	Varies	306,456	12.5	0.00
	Total transaction accounts		987,403	25.6			607,653	24.8	
Savings Accounts:									
None	Regular savings	100	203,487	5.3	0.40	100	118,251	4.8	0.40
None	MMDA	1,000	901,384	23.3	1.47	1,000	545,607	22.2	1.14
	Total savings accounts		1,104,871	28.6			663,858	27.0	
Time Deposits:									
Less than 90 days	Fixed term, fixed rate	5,000	3,142	0.1	1.19	5,000	2,803	0.1	0.50
3 months	Fixed term, fixed rate	500	9,172	0.2	1.49	500	5,772	0.2	0.75
6 months	Fixed term, fixed rate	500	43,959	1.1	1.79	500	34,260	1.4	0.85
9 months	Fixed term, adjustable rate	5,000	88,170	2.3	2.47	5,000	87,471	3.6	0.90
11 months	Fixed term, fixed rate	500	120,535	3.1	2.03 - 2.08	500	49,383	2.0	1.24
12 months	Fixed term, fixed rate	500	56,905	1.5	2.13	500	54,770	2.2	0.90
12 months	Fixed term, adjustable rate	N/A	2,103	0.1	N/A(1)	N/A	2	0.0	N/A(1)
15 months	Fixed term, adjustable rate	5,000	43,159	1.1	2.03 - 2.18	5,000	75,121	3.1	1.00
18 months	Fixed term, fixed rate	500	21,422	0.6	2.28 - 2.37	500	22,812	0.9	1.49
24 months	Fixed term, fixed rate	500	52,276	1.4	2.67	500	32,326	1.3	1.83
36 months	Fixed term, fixed rate	500	127,762	3.3	3.11	500	120,333	4.9	2.52
Greater than 36 months	Fixed term, fixed rate	500	373,449	9.7	3.70	500	204,662	8.3	3.06
18 months	Variable rate, IRA	100	3,987	0.1	3.13	100	4,214	0.2	1.53
18 months	Fixed rate, IRA	500	104,274	2.7	1.24	500	6,460	0.3	1.24
36 months	Variable rate, IRA	2,000	6,738	0.2	N/A(1)	2,000	10,491	0.4	N/A(1)
9 months	Mini-jumbos	80,000	7,914	0.2	1.05	80,000	5,442	0.2	1.05
6 months	Jumbos	100,000	330,568	8.6	1.10	100,000	353,059	14.4	1.10
Less than 1 year	Brokered	N/A	375,487	9.5	1.33	N/A	114,184	4.7	1.33
	Total time deposits		1,771,022	45.8			1,183,565	48.2	
	Total deposits		$ 3,863,296	100.0			$ 2,455,076	100.0	

(1) Not currently offered.

The following table sets forth the composition of Sterling s deposit accounts at the dates indicated:

	December 31,					
	2004			2003		
		Amount	Percentage of Total Deposits		Amount	Percentage of Total Deposits
	(Dollars in thousands)					
NOW checking	$	413,217	10.7	$	301,197	12.3
Commercial checking		574,186	14.9		306,456	12.5
Regular savings		203,487	5.3		118,251	4.8
MMDA		901,384	23.3		545,607	22.2
Variable-rate time deposits:						
9-36 months		142,218	3.7		177,300	7.2
Fixed-rate time deposits:						
1-11 months		890,614	23.1		564,903	23.0
12-35 months		284,223	7.4		165,920	6.8
36-240 months		453,967	11.6		275,442	11.2
Total deposits	$	3,863,296	100.0	$	2,455,076	100.0

A majority of Sterling s depositors are residents of the states of Washington, Oregon, Idaho and Montana. Sterling has 130 automated teller machines (ATM) to better serve customers in those markets. Customers also can access ATMs operated by other financial institutions. Sterling is a member of The Exchange and the Plus System ATM networks that allow participating customers to deposit or withdraw funds from NOW checking accounts, MMDA and savings accounts at numerous locations in the United States and internationally.

Borrowings. Deposit accounts are Sterling s primary source of funds. Sterling does, however, rely upon advances from the FHLB Seattle to Sterling Savings Bank and upon reverse repurchase agreements with major broker/dealers and financial entities to supplement its funding and to meet deposit withdrawal requirements. See MD&A Liquidity and Capital Resources.

The FHLB Seattle is part of a system that consists of 12 regional Federal Home Loan Banks (the FHL Banks) each subject to Federal Housing Finance Board supervision and regulation, and that function as a central reserve bank providing credit to savings institutions. As a condition of membership in the FHLB Seattle, Sterling Savings Bank is required to own stock of the FHLB Seattle in an amount determined by a formula based upon the larger of Sterling Savings Bank s total mortgages outstanding or total advances from the FHLB Seattle. At December 31, 2004, Sterling Savings Bank held more than the minimum FHLB Seattle stock ownership requirement. The stock of the FHLB Seattle always has been redeemable at par value, but there can be no assurance that this always will be the case.

As a member of the FHLB Seattle, Sterling Savings Bank can apply for advances on the security of its FHLB Seattle stock and certain of its mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the United States or its agencies), provided certain standards related to creditworthiness, including a minimum ratio of total capital assets of at least five percent, are met. Each available credit program has its own interest rate and range of maturities. At December 31, 2004, Sterling had advances totaling $1.64 billion from the FHLB Seattle, which mature from 2005 through 2016 at interest rates ranging from 1.83% to 8.08%. See MD&A Liquidity and Capital Resources and Note 9 of Notes to Consolidated Financial Statements.

Sterling also borrows funds under reverse repurchase agreements with major broker/dealers and financial entities pursuant to which it sells investments (generally U.S. agency and ABS) under an agreement to buy them back at a specified price at a later date. These agreements to repurchase are deemed to be borrowings collateralized by the investments and ABS sold. Sterling uses these borrowings to supplement deposit gathering for funding the origination of loans. Sterling had $779.0 million and $360.6 million in wholesale and retail reverse repurchase agreements outstanding at December 31, 2004 and 2003, respectively. The use of reverse repurchase agreements may expose

Sterling to certain risks not associated with other borrowings, including IRR and the possibility that additional collateral may have to be provided if the market value of the pledged collateral declines. For additional information regarding reverse repurchase agreements, see MD&A Asset and Liability Management, MD&A Liquidity and Capital Resources and Note 10 of Notes to Consolidated Financial Statements.

Other Borrowings. Sterling has a variable-rate term note with U.S. Bank, N.A. (U.S. Bank) with a balance of $19.0 million outstanding at December 31, 2004. This note matures on September 17, 2007. Interest accrues at the 30-day London Interbank Offering Rate (LIBOR) plus 2.00% and is payable monthly. The term note is collateralized by a majority of the common and preferred stock of Sterling Savings Bank. See Note 11 of Notes to Consolidated Financial Statements.

At December 31, 2004, Sterling had outstanding $108.7 million in various series of Trust Preferred Securities issued to investors. See Note 11 of Notes to Consolidated Financial Statements.

The following table sets forth certain information regarding Sterling s short-term borrowings as of and for the periods indicated:

	Years Ended December 31, 2004	2003 (Dollars in thousands)	2002
Maximum amount outstanding at any month-end during the period:			
Short-term reverse repurchase agreements	$ 779,012	$ 285,637	$ 154,769
Short-term advances	648,648	372,500	238,975
Average amount outstanding during the period:			
Short-term reverse repurchase agreements	$ 630,057	$ 56,518	$ 45,728
Short-term advances	517,499	197,500	55,641
Weighted average interest rate paid during the period:			
Short-term reverse repurchase agreements	2.22%	1.82%	1.85%
Short-term advances	2.77%	2.73%	4.69%
Weighted average interest rate paid at end of period:			
Short-term reverse repurchase agreements	2.53%	1.59%	1.83%
Short-term advances	3.36%	2.51%	3.69%

The following table sets forth certain information concerning Sterling s outstanding borrowings for the periods indicated:

	December 31,								
	2004			2003			2002		
		Amount	%		Amount	%		Amount	%
	(Dollars in thousands)								
FHLB Seattle advances:									
Short-term	$	562,238	22.1	$	408,685	26.8	$	238,975	19.1
Long-term		1,073,695	42.1		617,346	40.4		635,540	50.8
Securities sold subject to reverse repurchase agreements and funds purchased:									
Short-term		780,012	30.6		288,137	18.9		154,769	12.3
Long-term		0	0.0		75,000	4.9		95,000	7.6
Floating Rate Notes Due 2006 (1)		0	0.0		30,000	2.0		30,000	2.4
Term note payable		19,000	0.7		22,000	1.4		25,000	2.0
Trust Preferred Securities		108,685	4.3		80,415	5.3		64,000	5.1
Other		4,137	0.2		5,583	0.3		8,682	0.7
Total borrowings	$	2,547,767	100.0	$	1,527,166	100.0	$	1,251,966	100.0
Weighted average interest rate at end of period			3.36%			3.40%			4.50%

(1) These notes were redeemed in full in December 2004.

Subsidiaries

Sterling s principal subsidiary is Sterling Savings Bank. Sterling Savings Bank has three principal subsidiaries, which have been previously described: Action Mortgage, INTERVEST and Harbor Financial. Additionally, Sterling and Sterling Savings Bank have the following other wholly owned, direct subsidiaries:

***Sterling Financial Corporation*.**

(1) Sterling Capital Trust II (SCT-II) was organized in July 2001 as a Delaware business trust. Sterling owns all the common equity of SCT-II. The sole asset of SCT-II is the Junior Subordinated Debentures-II issued by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

(2) Sterling Capital Trust III (SCT-III) was organized in April 2003 as a Delaware business trust. Sterling owns all the common equity of SCT-III. The sole asset of SCT-III is the Junior Subordinated Debentures-III

issued by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

(3) Sterling Capital Trust IV (SCT-IV) was organized in May 2003 as a Delaware business trust. Sterling owns all the common equity of SCT-IV. The sole asset of SCT-IV is the Junior Subordinated Debentures-IV issued by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

(4) Sterling Capital Statutory Trust V (SCT-V) was organized in May 2003 as a Connecticut business trust. Sterling owns all the common equity of SCT-V. The sole asset of SCT-V is the Junior Subordinated Debentures -V issued by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

(5) Sterling Capital Trust VI (SCT-VI) was organized in June 2003 as a Delaware business trust. Sterling owns all the common equity of SCT-VI. The sole asset of SCT-VI is the Junior Subordinated Debentures-VI issued by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

(6) Klamath First Capital Trust I (KCT-I) was organized in July 2001 as a Delaware business trust. Sterling owns all the common equity of KCT-I. The sole asset of KCT-I is the Junior Subordinated Debentures-I issued by KFBI and assumed by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

(7) Klamath First Capital Trust II (KCT-II) was organized in April 2002 as a Delaware business trust. Sterling owns all the common equity of KCT-II. The sole asset of KCT-II is the Junior Subordinated Debentures-II issued by KFBI and assumed by Sterling. See Note 11 of Notes to Consolidated Financial Statements.

(8) Tri-Cities Mortgage Corporation was organized to engage in real estate development.

***Sterling Savings Bank*.**

(1) The Dime Service Corporation was acquired as part of a merger in February 2003. The corporation is currently inactive.

(2) Evergreen Environmental Development Corporation was organized to engage in real estate development.

(3) Evergreen First Service Corporation owns all of the outstanding capital stock of Harbor Financial, through which Sterling offers tax-deferred annuities, mutual funds and other financial products.

(4) Fidelity Service Corporation acts as a trustee in the reconveyance of deeds of trust originated by Sterling Savings Bank and Action.

(5) Pacific Cascades Financial, Inc. was acquired in January 2004. The corporation acts as trustee in the reconveyance of deeds of trust.

(6) Peter W. Wong Associates, Inc. was organized to offer alternative financial services.

(7) Source Capital Corporation was acquired in September 2001. The corporation holds and services loans.

(8) Source Capital Leasing Corporation was acquired in September 2001, and was organized to engage in corporate leasing.

(9) Tri-West Mortgage, Inc. was organized to engage in mortgage banking.

Competition

Sterling faces strong competition, both in attracting deposits and in originating, purchasing and selling loans, from savings and loan associations, mutual savings banks, credit unions, commercial banks and other institutions, many of which have greater resources than Sterling. Sterling also faces strong competition in marketing financial products such as annuities, mutual funds and other financial products and in pursuing acquisition opportunities. Some or all of these competitive businesses operate in Sterling s market areas.

Personnel

As of December 31, 2004, Sterling, including its subsidiaries, had 1,624 full-time equivalent employees. Employees are not represented by a collective bargaining unit. Sterling believes it has good relations with its employees.

Environmental Laws

Environmentally related hazards have become a source of high risk and potentially unlimited liability for financial institutions relative to their loans. Environmentally contaminated properties owned by an institution s borrowers may result in a drastic reduction in the value of the collateral securing the institution s loans to such borrowers, high environmental clean-up costs to the borrower affecting its ability to repay the loans, the subordination of any lien in favor of the institution to a state or federal lien securing clean-up costs, and liability to the institution for clean-up costs if it forecloses on the contaminated property or becomes involved in the management of the borrower. To minimize this risk, Sterling may require an environmental examination and report with respect to the property of any borrower or prospective borrower if circumstances affecting the property indicate a potential for contamination, taking into consideration the potential loss to the institution in relation to the burdens to the borrower. This examination must be performed by an engineering firm experienced in environmental risk studies and acceptable to the institution, with the costs of such examinations and reports being the responsibility of the borrower. These costs may be substantial and may deter a prospective borrower from entering into a loan transaction with Sterling. Sterling is not aware of any borrower who is currently subject to any environmental investigation or clean-up proceeding that is likely to have a material adverse effect on the financial condition or results of operations of Sterling.

Regulation

Introduction. *The following is not intended to be a complete discussion but is intended to be a summary of some of the most significant provisions of laws applicable to Sterling and its subsidiaries.*

Sterling is a savings and loan holding company and as such is subject to OTS regulations, examinations and reporting requirements. Sterling Savings Bank is chartered by the state of Washington and its deposits are insured by the FDIC. Sterling Savings Bank is subject to comprehensive regulation, examination and supervision by the OTS, the FDIC and the Washington Supervisor. Furthermore, certain transactions and savings deposits are subject to regulations and controls promulgated by the Federal Reserve Board (the Fed).

Savings and Loan Holding Company Regulation. Sterling is registered as a savings and loan holding company under the Home Owners Loan Act (the HOLA). The HOLA generally permits a savings and loan holding company to engage in activities which are unrelated to the operation of a savings and loan association, provided the holding company controls only one savings and loan association and such savings and loan association meets the Qualified Thrift Lender Test (the QTL Test), as described under *Qualified Thrift Lender*. Sterling presently controls only one savings and loan association, Sterling Savings Bank, which at December 31, 2004, met the QTL Test.

If Sterling Savings Bank fails to meet the QTL Test in the future, Sterling will become subject to restrictions on the activities in which it may engage. Such activities would generally be limited to any activity that the Fed by regulation has determined is permissible for bank holding companies pursuant to Section 4(c) of the Bank Holding Company Act of 1956, as amended (unless limited or prohibited by the OTS by regulation), and certain other limited services and activities. Although Sterling Savings Bank expects to remain in compliance with the QTL Test in the future, there can be no assurance in this regard.

Under the HOLA, no person may acquire control of a savings association or a savings and loan holding company without the prior approval of the OTS. As a savings and loan holding company, Sterling is prohibited from acquiring, without the prior approval of the OTS: (i) control of another savings association or a savings and loan holding company; (ii) the assets of another savings association or savings and loan holding company by merger, consolidation or purchase; (iii) more than 5% of the voting shares of a savings association or a savings and loan holding company which is not a subsidiary of Sterling; or (iv) control of a depository institution, the accounts of which are not insured by the FDIC.

The HOLA authorizes the OTS to issue a directive to a savings and loan holding company and any of its subsidiaries if the OTS determines that there is reasonable cause to believe that the continuation by the holding company of any activity constitutes a serious risk to the financial safety, soundness or stability of the holding company s subsidiary savings association. The OTS may impose restrictions through such directive to limit such risk, including limiting: (i) payment of dividends by the savings association; (ii) transactions between the savings association, the holding company and the subsidiaries or affiliates of either; and (iii) any activities of the savings association that might create a serious risk that the liabilities of the holding company and its other affiliates may be imposed on the savings association. Such a directive has the same effect as a final cease and desist order. The issuance of the directive can be appealed to the Director of the OTS.

The Fair and Accurate Credit Transactions Act. In December 2003, the Fair and Accurate Credit Transactions Act of 2003 (the FACT) was signed into law. The FACT includes many provisions concerning national credit reporting standards and permits consumers, including Sterling s customers, to opt out of information sharing among affiliated companies for marketing purposes. The FACT also requires financial institutions to provide consumers certain information regarding the consumer s credit score. Additionally, financial institutions must notify their customers if they report negative information about them to credit bureaus or if the credit terms offered to a customer are materially less favorable than the most favorable terms offered to a substantial portion of customers because of information in the customer s credit report. The FACT also contains provisions intended to help detect identity theft.

The Sarbanes-Oxley Act. In July 2002, the Sarbanes-Oxley Act of 2002 (the SOA) was enacted in response to public concerns regarding corporate accountability. The stated goals of the SOA are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The SOA represents a comprehensive revision of laws affecting corporate governance, accounting obligations and corporate reporting. The SOA generally applies to all companies that file or are required to file periodic reports with the SEC under the Securities Exchange Act of 1934, as amended (Exchange Act).

The SOA includes new disclosure requirements and corporate governance rules, requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules, and mandates further studies of certain issues by the SEC and the Comptroller General. In particular, the SOA establishes: new requirements for audit committees; additional responsibilities regarding financial statements of reporting companies; new standards for auditors and regulation of audits; increased disclosure and reporting obligations for a reporting company and its directors and executive officers; and new civil and criminal penalties for violation of the securities laws. The SEC has enacted rules to implement various of the provisions with respect to, among other matters, disclosure in periodic filings pursuant to the Exchange Act.

The U.S.A. Patriot Act. In December 2001, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the Patriot Act) became effective. The Patriot Act is designed to combat money laundering and terrorist financing while protecting the U.S. financial system. The Patriot Act imposes enhanced policy, record keeping and due diligence requirements on domestic financial institutions. The Patriot Act also amended the Bank Secrecy Act to facilitate access to customer account information by government officials while immunizing banks from liability for releasing such information.

The Gramm-Leach-Bliley Act. In November 1999, the Gramm-Leach-Bliley Act (the GLBA) was enacted. The GLBA is also known as the Financial Services Modernization Act due to its sweeping overhaul of the financial services industry. Enactment of the GLBA allows banks, securities firms and insurance companies to affiliate. Now financial institutions can act as financial supermarkets offering customers one stop shopping for bank accounts, insurance policies and securities transactions.

The GLBA, among other things, provides customers with greater financial privacy by requiring financial institutions to safeguard their nonpublic personal information. Financial institutions must advise customers of their policies regarding sharing nonpublic personal information with non-affiliated third parties and allow customers to opt-out of such sharing (subject to several exceptions related mainly to processing customer-initiated transactions and compliance with current law).

The Home Ownership and Equity Protection Act of 1994. The Federal Reserve Board has adopted amendments to the Home Ownership and Equity Protection Act of 1994 (HOEPA), which expand the protections of HOEPA to cover more transactions and prohibit certain practices deemed harmful to borrowers. If a loan qualifies as a HOEPA loan, certain practices and terms on high-cost mortgages are restricted and require special consumer disclosures. The interest rate trigger on first-time liens used to determine whether a loan qualifies as a HOEPA loan has been lowered from 10% to 8% and the cost of single-premium credit insurance products has been added to the points and fees test. As a result, more of Sterling s loans are expected to be subject to HOEPA restrictions and disclosure requirements.

The Federal Deposit Insurance Corporation Improvement Act of 1991. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) provides for expanded regulation of depository institutions and their affiliates, including parent holding companies. FDICIA further provides the OTS with broad powers to take prompt corrective action to resolve problems of insured depository institutions. The extent of these powers depends upon whether the institution in question is well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized.

Under OTS regulations that implement the prompt corrective action system mandated by FDICIA, an institution is well capitalized if its total risk-based capital ratio (the ratio of qualifying total capital to risk-weighted assets) is 10% or more, its Tier 1 risked-based capital ratio (the ratio of core (Tier 1) capital to risk-weighted assets) is 6% or more, its core (Tier 1) capital ratio (the ratio of core (Tier 1) capital to total assets) is 5% or more and it is not subject to any written agreement, order or directive to meet a specified capital level. At December 31, 2004, Sterling Savings Bank met the standards for a well capitalized institution.

An institution, which is undercapitalized, must submit a capital restoration plan to the OTS. The plan may be approved only if the OTS determines it is likely to succeed in restoring the institution s capital and will not appreciably increase the risks to which the institution is exposed. The institution s performance under the plan must be guaranteed by any company, which controls the institution, up to a maximum of 5% of the institution s assets. The OTS also may require an undercapitalized institution to take various actions deemed appropriate to minimize the potential losses to the deposit insurance fund. Institutions that are significantly undercapitalized or critically undercapitalized are subject to additional sanctions.

FDICIA directs each bank regulatory agency and the OTS to review its capital standards every two years to determine whether those standards require sufficient capital to facilitate prompt corrective action to prevent or minimize loss to the deposit insurance funds. FDICIA, as amended, also requires the OTS to prescribe minimum operational and managerial standards and standards for asset quality, earnings and stock valuation for savings institutions. Any savings institution that fails to meet such standards may be required to submit a plan for corrective action. If a savings institution fails to submit or implement an acceptable plan, the OTS may require the institution to take any action the OTS determines will best carry out the purpose of prompt corrective action.

Under FDICIA, only a well capitalized depository institution may accept brokered deposits without prior regulatory approval. FDICIA also requires annual examinations of all insured depository institutions by the appropriate federal banking agency, with some exceptions for small, well capitalized institutions and state-chartered institutions examined by state regulators. The federal banking agencies are required to set compensation standards for insured depository institutions that prohibit excessive compensation, fees or benefits to officers, directors, employees and principal shareholders. FDICIA also contains a number of consumer banking provisions, including disclosure requirements and substantive contractual limitations with respect to deposit accounts. FDICIA also greatly expanded the range of merger, purchase and assumption, and deposit transfer transactions involving banks and savings associations that are exempt from payment of exit and entry fees as transfers of deposits between the FDIC s Bank Insurance Fund and its Savings Association Insurance Fund (SAIF). Many of the provisions of FDICIA have been implemented through the adoption of regulations by the federal banking agencies.

Regulatory Capital Requirements. Pursuant to the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), the OTS adopted regulations implementing new capital standards applicable to all savings associations, including Sterling Savings Bank. Such capital standards require that savings associations maintain: (i) capital of not less than 1.5% of adjusted total assets; (ii) core (Tier 1) capital of not less than 4% of adjusted total assets; and (iii) total risk-based capital of not less than 8% of risk-weighted assets. As of December 31, 2004, Sterling Savings Bank met all regulatory capital requirements. For additional information, see MD&A Liquidity and Capital Resources.

Core (Tier 1) capital consists of: common shareholders equity, including retained earnings; noncumulative perpetual preferred stock; certain non-withdrawable and pledged deposits; and minority interests in equity accounts of fully consolidated subsidiaries. In calculating core (Tier 1) capital, certain items must be deducted. These items are goodwill and other intangible assets, nonqualifying purchased mortgage servicing rights and investments (whether debt or equity) in subsidiaries engaged as of April 1989 in activities, which were permissible for national banks. The face amount of credit-enhancing, interest-only-strips that exceeds 25% of Tier 1 capital must also be deducted from core (Tier 1) capital. With respect to purchased mortgage servicing rights, the amount that qualifies to be included in core (Tier 1) capital is the lower of (a) 90% of fair market value if determinable, (b) 90% of original cost, or (c) the current amortized book value.

The total risk-based capital requirement is an amount equal to 8% of risk-adjusted assets. A risk weight is assigned to both the on-balance sheet assets and off-balance sheet commitments of a savings association. Risk weights range from zero to 100% depending on the type of asset.

Both core (Tier 1) capital and supplementary (Tier 2) capital may be used to meet the total risk-based capital requirement, although Tier 2 capital is limited to 100% of Tier 1 capital. For purposes of the total risk-based capital requirement, Tier 2 capital includes permanent capital instruments such as cumulative perpetual preferred stock, perpetual or mandatory convertible subordinated debt, maturing capital instruments such as subordinated debt, intermediate-term preferred stock, commitment notes and certain grandfathered mandatory redeemable preferred stock (although the amount included declines as the instrument approaches maturity), and general valuation loan loss allowances up to a maximum of 1.25% of risk-weighted assets.

The following tables set forth Sterling Savings Bank s core (Tier 1) capital, core (Tier 1) risk-based capital and total risk-based capital positions as reported on the quarterly Thrift Financial Report at December 31, 2004 and 2003. See MD&A Capital.

	December 31,					
	2004			2003		
	Core (Tier 1) Capital					
		Dollars	%(1)		Dollars	%
	(Dollars in thousands)					
Total shareholders equity	$	566,420	8.31	$	346,989	8.18
Adjustment:						
Unrealized (gains) losses on securities		9,470	0.14		15,193	0.36
Less:						
Nonqualifying servicing assets		(52)	0.00		(317)	(0.01)
Goodwill and other intangibles, net		(124,920)	(1.83)		(46,479)	(1.10)
Total core (Tier 1) capital (2)		450,918	6.62		315,386	7.43
Core (Tier 1) capital requirement		272,599	4.00		169,711	4.00
Core (Tier 1) capital excess	$	178,319	2.62	$	145,675	3.43

	Core (Tier 1) Risk-Based Capital					
		Dollars	%		Dollars	%
	(Dollars in thousands)					
Total core (Tier 1) capital	$	450,918	9.73	$	315,386	9.89
Core (Tier 1) risk-based capital requirement		185,404	4.00		127,313	4.00
Core (Tier 1) risk-based capital excess	$	265,514	5.73	$	188,073	5.89

	Total Risk-Based Capital					
		Dollars	%		Dollars	%
	(Dollars in thousands)					
Total core (Tier 1) capital	$	450,918	9.73	$	315,386	9.90
General valuation allowances		45,834	0.99		32,707	1.03
Low-level recourse deduction		0	0.00		(723)	(0.02)
Total risk-based capital		496,752	10.72		347,370	10.91
Risk-based capital requirement		370,807	8.00		254,627	8.00
Risk-based capital excess	$	125,945	2.72	$	92,743	2.91

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(1) Ratio of core (Tier 1) capital to adjusted total assets for the core (Tier 1) capital ratio and ratio of core (Tier 1) and total risk-based capital to risk-weighted assets for core (Tier 1) risk-based and total risk-based capital.

(2) Sterling exceeds well capitalized requirements under FDICIA, which are 10% for total risk-based capital, 6% for Tier 1 risk-based capital, and 5% for Tier 1 leverage capital.

Savings associations that fail to meet the core (Tier 1) or risk-based capital requirements are subject to a number of sanctions or restrictions. Specifically, under FIRREA, if such failure occurs the OTS must prohibit any asset growth, except that the OTS may permit growth in an amount not in excess of net interest credited to the savings association s deposit liabilities, if: (i) the savings association obtains the prior approval of the OTS; (ii) any increase in assets is accompanied by an increase in core (Tier 1) capital in an amount not less than 3.0% of the increase in assets; (iii) any increase in assets is accompanied by an increase in capital not less in percentage amount than required under the risk-based capital standards then applicable; (iv) any increase in assets is invested in low-risk assets; and (v) the savings association s ratio of core (Tier 1) capital to total assets is not less than the ratio existing on January 1, 1991.

The OTS also may require any savings association not in compliance with capital standards (including any individual minimum capital requirement) to comply with a capital directive issued by the OTS. Such a capital directive may order the savings association to: (a) achieve its minimum capital requirements by a specified date; (b) adhere to a compliance schedule for achieving its minimum capital requirements; (c) submit and adhere to a capital plan acceptable to the OTS; and/or (d) take other actions, including reducing its assets or rate of liability growth and/or restricting its payment of dividends to reach the required capital levels. The OTS, by such capital directive, enforcement proceedings or otherwise, may require an association not in compliance with the capital requirements to: (i) increase the amount of its regulatory capital to a specified level; (ii) convene a meeting with the OTS supervision staff for the purpose of accomplishing the objectives of the regulations; (iii) reduce or limit the rate of interest that may be paid on savings accounts; (iv) limit the receipt of deposits to those made to existing accounts; (v) cease or limit lending or making a particular loan or category of loan; (vi) cease or limit the purchase of loans or making specified other investments; (vii) limit operational expenditures to specific levels; (viii) increase liquid assets and maintain such increased liquidity at specified levels; or (ix) take such other action or actions as the OTS may deem necessary or appropriate for the safety and soundness of the savings association or the protection of its depositors. The material failure of a savings association to comply with any plan, regulation, written agreement, order or directive issued will be treated as an unsafe or unsound practice that could result in the imposition of certain penalties or sanctions including, but not limited to, the assessment of civil monetary penalties, the issuance of a cease and desist order or the appointment of a conservator or receiver.

Any savings association that does not meet its regulatory capital requirements may not accept, without a written waiver from the OTS, brokered deposits if such deposits, together with any existing brokered deposits outstanding, would exceed 5.0% of the association s total deposits. In addition, the FDIC prohibits, with certain exceptions, an insolvent institution from accepting any brokered deposits. An insolvent institution is defined as any insured depository institution that does not meet the minimum capital requirements applicable with respect to such institution. This prohibition includes any renewal of an account in any insolvent institution and any rollover of any amount on deposit. The FDIC may waive this restriction upon application by an insured depository institution and a finding that the acceptance of such deposits does not constitute an unsafe or unsound practice with respect to such institution. As a well capitalized institution, Sterling is qualified to have brokered deposits without prior approval from the OTS. Sterling had $375.3 million and $114.2 million in brokered deposits at December 31, 2004 and 2003, respectively.

A savings association that is not in compliance with its capital requirements may apply to the OTS for an exemption from the sanctions and penalties imposed upon a savings association for failure to comply with its minimum capital standards. Pursuant to FIRREA, the OTS may approve an application for a capital exemption if such exemption would pose no significant risk to the affected insurance fund, the savings association s management is competent, the savings association is in compliance with all applicable statutes, regulations, orders and supervisory agreements and directives and the savings association s management has not engaged in insider dealing, speculative practices or any other activities that could have jeopardized the association s safety and soundness or contributed to impairing the association s capital. Any application for a capital exemption must be accompanied by an acceptable capital plan. If a savings association receives approval of a capital exemption and operates in accordance with an acceptable capital plan, it will be deemed to be in compliance with its capital standards for purposes of OTS capital regulation only. The savings association must request and receive approval of specific, express exemptions from the provisions of other rules, regulations and policy statements as part of the accepted capital plan to be deemed in capital compliance for purposes of such other rules, regulations and policy statements.

Federal Deposit Insurance Corporation. Sterling s deposits are insured up to $100,000 per insured depositor (as defined by law and regulations) by the FDIC through the SAIF. The SAIF is administered and managed by the FDIC. The FDIC is authorized to conduct examinations of and to require reporting by SAIF member institutions. The FDIC may prohibit any SAIF member institution from engaging in any activity the FDIC determines by regulation or order poses a serious threat to the SAIF. The FDIC also has the authority to initiate enforcement actions against savings associations.

Deposits insured by SAIF are currently assessed at the rate of zero for well-capitalized institutions displaying little risk to the SAIF to $0.27 per $100 of domestic deposits for undercapitalized institutions displaying high risk. The SAIF assessment rate may increase or decrease as is necessary to maintain the designated SAIF reserve ratio of 1.25% of insured deposits.

The Financing Corporation (FICO), established by the Competitive Equality Banking Act of 1987, is a mixed-ownership government corporation whose purpose is to function as a financing vehicle for the Federal Savings & Loan Insurance Corporation. Outstanding FICO bonds, which are 30-year noncallable bonds, mature in 2017 through 2019. The FICO has assessment authority, separate from the FDIC s authority to assess risk-based premiums for deposit insurance, to collect funds from FDIC-insured institutions sufficient to pay interest on FICO bonds. The FDIC acts as a collection agent for the FICO. The FICO assessment rate, currently $0.40 per $100 of deposits, is adjusted quarterly.

The FDIC is empowered to initiate a termination of insurance proceeding in cases where the FDIC determines that an insured depository institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated an applicable law, regulation, order or condition imposed by the FDIC. The FDIC may deem failure to comply with applicable regulatory capital requirements an unsafe and unsound practice. If the FDIC terminates a savings association s deposit insurance, funds then on deposit continue to be insured for at least six months and up to two years after notice of such termination is provided to the account holders. Furthermore, if the FDIC initiates an insurance termination proceeding against a savings association that has no core (Tier 1) capital, the FDIC may issue a temporary order immediately suspending deposit insurance on all deposits received by such savings association.

Loans to Affiliates. As directed by HOLA, the OTS has revised the regulations governing transactions between thrifts and their affiliates and incorporated applicable provisions of Regulation W as adopted by the Federal Reserve Board. Effective April 1, 2003, Regulation W implements restrictions on affiliate transactions as provided in Sections 23A and 23B of the Federal Reserve Act (the FRA). Such transactions are subject to the restrictions of Sections 23A and 23B of the FRA in the same manner and to the same extent as if the savings association were a member bank as defined in the FRA, except that a savings association may not (i) extend credit to any affiliate engaged in activities that are impermissible for a bank holding company or (ii) purchase or invest in any securities of an affiliate other than shares of a subsidiary.

Section 23A of the FRA limits the aggregate amount of covered transactions with any one affiliate to 10% of the capital stock and surplus of the member bank. Covered transactions with all affiliates are limited to no more than 20% of the member bank s capital stock and surplus. Covered transactions are defined in Section 23A to include extending credit to, purchasing the assets of, issuing a guarantee, acceptance or letter of credit on behalf of, or investing in the stock or securities of, any affiliate. Covered transactions also include transactions between a member bank and a nonaffiliated third party to the extent that proceeds of the transactions are used for the benefit of or transferred to the affiliate. Section 23A also requires a bank to obtain specified levels of collateral for any extension of credit to an affiliate. Section 23B, in general, requires that any transaction with an affiliate be on terms and conditions no less favorable to the member bank than those applicable to transactions with unaffiliated entities. The OTS has recently adopted regulations further defining and clarifying the applicability of Section 23A and 23B to savings associations. The OTS has the authority to impose any additional restrictions on any transaction between a savings association and an affiliate that it determines are necessary to protect the safety and soundness of the association.

In addition, FIRREA provides that extensions of credit to executive officers, directors and principal shareholders of a savings association are governed by the FRA. The FRA requires prior approval by the board of directors of the bank before a loan can be made to an executive officer, director or 10% shareholder. In addition, such loan or extension of credit must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unaffiliated persons and may not involve more than the normal risk of repayment or present other unfavorable features. The FRA also prohibits any loan or extension of credit to an executive officer or a controlling shareholder if such loan or extension of credit (when aggregated with the amount of all other loans or extensions of credit then outstanding to such individual) would exceed the limits on loans to a single borrower applicable to national banks. The OTS may impose additional restrictions for safety and soundness reasons.

Loans-to-One-Borrower. Under FIRREA, the permissible amount of loans-to-one-borrower follows the national bank standard for all loans made by savings associations (except that loans-to-one-borrower not in excess of $500,000 may be made in any event). OTS regulations generally do not permit loans-to-one-borrower to exceed 15% of unimpaired capital and unimpaired surplus. Loans in an amount equal to an additional 10% of unimpaired capital and unimpaired surplus also may be made to a borrower if the loans are fully secured by readily marketable collateral. In addition, institutions, which meet applicable capital requirements, may make domestic residential housing development loans in an amount up to the lesser of $30.0 million or 15% of the institution s unimpaired capital and unimpaired surplus, subject to certain conditions. At December 31, 2004, Sterling s loans-to-one-borrower limit was $74.5 million, which management believes is adequate to allow for loan originations.

Qualified Thrift Lender. Under the QTL Test, an institution generally is required to invest at least 65% of its portfolio assets (as defined in the OTS regulations) in qualified thrift investments on a monthly average basis in nine out of every twelve months. Qualified thrift investments include, in general, loans, securities and other investments that are related to housing and small business. At December 31, 2004, Sterling s qualified thrift investments were 82.0% of portfolio assets. An institution s failure to remain a qualified thrift lender may result in: (1) limitations on new investments and activities; (2) imposition of branching restrictions; (3) redefinition of borrowing privileges at the FHLB Seattle; and (4) limitations on the payment of dividends.

Restriction on Business Banking Loans. As a thrift, Sterling is permitted to hold no more than 20% of its assets in certain business banking loans as defined by the HOLA. At December 31, 2004, Sterling had $1.0 billion in such loans, or 14.5% of total assets. In addition, Sterling is permitted to hold no more than 10% of its assets in certain business loans that do not qualify as small business loans as defined by the OTS. At December 31, 2004, Sterling had $418.4 million in such loans, or 6.0% of total assets.

Community Reinvestment. Under the Community Reinvestment Act (CRA), as implemented by the OTS regulations, a savings institution has a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions, nor does it limit an institution s discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires the OTS, in connection with its examination of a financial institution, to assess the institution s record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by such institutions. The CRA requires public disclosure of an institution s CRA rating and requires the OTS to provide a written evaluation of an institution s CRA performance utilizing a four-tiered descriptive rating system of outstanding, satisfactory, needs to improve or substantial noncompliance. Sterling s current CRA rating is satisfactory.

Change of Control. Under applicable statutes and regulations, a person may not acquire control of a savings association without the prior approval of the OTS and the Washington Supervisor. Control is conclusively deemed to be acquired when, among other things, a person, either alone or acting in concert with others, acquires more than 25% of any class of voting stock of a savings association. Under federal statutes and regulations, a rebuttable presumption of control arises if a person acquires, either alone or acting in concert with others, more than ten percent of any class of voting stock of a savings association and is subject to a control factor, or acquires more than 25% of any class of stock and is subject to a control factor. A person is subject to a control factor as a result of specified ownership levels of the savings association s debt or equity or as a result of certain relationships with the savings association.

As indicated above, if a person s ownership of the savings association stock is below the threshold levels for control, such person may nevertheless be deemed to be acting in concert with one or more other persons who own stock in the savings association, in which case all of the stock ownership of each person acting in concert will be aggregated and attributed to each member of the group, which could thereby put each one over the control threshold. Under certain circumstances, acquirers will be presumed to be acting in concert. For example: (i) a company will be presumed to be acting in concert with a controlling shareholder or management official; (ii) a company controlling or controlled by another company and companies under common control will be presumed to be acting in concert; and (iii) persons will be presumed to be acting in concert where they constitute a group under Section 13 or the proxy rules under Section 14 of the Exchange Act.

***Restrictions on Activities of State-Chartered Associations*.** FIRREA prohibits a state-chartered savings association from engaging in any type of activity or any activity in an amount that is not permissible for a federal savings association unless (i) the FDIC has determined that such activity poses no threat to the insurance fund, and (ii) the savings association continues to be in compliance with applicable capital requirements. If the FDIC determines that the amount of such activity does not pose a significant threat to the insurance fund, an association that is in compliance with applicable capital requirements may engage in activities in an amount greater than that permissible for a federal savings association. FIRREA also prohibits a state-chartered savings association from acquiring or retaining any equity investment (other than shares in certain service corporations) of a type or in an amount not permissible for a federal savings association. A savings association must divest any such equity investment as quickly as can be prudently done.

***Restrictions on Capital Distributions by Savings Associations*.** The OTS has adopted a capital distribution regulation that limits the ability of savings institutions to make capital distributions. Certain factors are considered by the OTS in determining whether to permit a savings institution to pay dividends, including, among other things, whether an institution meets applicable capital requirements. Those savings institutions that meet the applicable capital requirements have discretion in making capital distributions, while those with lower capitalization have less discretion in this regard and, in some cases, are required to seek the approval of the OTS before making such distributions.

Sterling s income is derived primarily from dividends to the extent they are declared and paid by Sterling Savings Bank. Current OTS regulations require Sterling Savings Bank to give the OTS 30 days advance notice of any proposed declaration of dividends to Sterling, as its holding company. The OTS has approved all Sterling Savings Bank preferred stock dividend payments to Sterling to date, but there can be no assurance as to the approval of future dividends.

***Federal Reserve System*.** Sterling Savings Bank is subject to various regulations promulgated by the Fed, including, among others, Regulation B (Equal Credit Opportunity), Regulation D (Reserves), Regulation E (Electronic Fund Transfers), Regulation Z (Truth in Lending), Regulation CC (Availability of Funds) and Regulation DD (Truth in Savings). Regulation D requires noninterest-bearing reserve maintenance in the form of either vault cash or funds on deposit at the Federal Reserve Bank of San Francisco or another designated depository institution in an amount calculated by formula. The balances maintained to meet the reserve requirements imposed by the Fed may be used to satisfy liquidity requirements. As of December 31, 2004, Sterling Savings Bank met these requirements.

Under the provisions of the Depository Institutions Deregulation and Monetary Control Act of 1980, savings and loan associations, like Sterling Savings Bank, also have authority to borrow from the Federal Reserve Bank discount window, but Federal Reserve regulations require associations to exhaust all FHL Bank sources before borrowing from the Fed.

***Federal Taxation*.** Sterling is subject to federal income taxation under the Internal Revenue Code of 1986, as amended, in the same manner as other corporations. Sterling files consolidated federal income tax returns on the accrual basis. See Note 12 of Notes to Consolidated Financial Statements.

State Law and Regulation. Sterling Savings Bank is a Washington State-chartered institution and is subject to regulation by the Washington Supervisor, which conducts regular examinations to ensure that Sterling Savings Bank s operations and policies conform with sound industry practice. The liquidity and other requirements set by the Washington Supervisor are generally no stricter than the liquidity and other requirements set by the OTS. State law regulates the amount of credit that can be extended to any one person or marital community and the amount of money that can be invested in any one property. Without the Washington Supervisor s approval, Sterling Savings Bank currently cannot extend credit to any one person or marital community in an amount greater than 2.5% of Sterling Savings Bank s total assets. State law also regulates the types of loans Sterling Savings Bank can make. Without the Washington Supervisor s approval, Sterling Savings Bank cannot currently invest more than 10% of its total assets in other corporations. Sterling Savings Bank also operates branches within the states of Oregon, Idaho and Montana and therefore its operations in these states are subject to the supervision of the Oregon Department of Consumer and Business Services, the Idaho Department of Finance and the Montana Department of Finance, as applicable.

Forward-Looking Statements

From time to time, Sterling and its senior managers have made and will make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements may be contained in this report and in other documents that Sterling files with the Securities and Exchange Commission. Such statements may also be made by Sterling and its senior managers in oral or written presentations to analysts, investors, the media and others. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Also, forward-looking statements can generally be identified by words such as may, could, should, would, believe, anticipate, estimate, seek, expect, intend, plan and similar expressions.

Forward-looking statements provide our expectations or predictions of future conditions, events or results. They are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. These statements speak only as of the date they are made. We do not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made. There are a number of factors, many of which are beyond our control, that could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements. These factors, some of which are discussed elsewhere in this report, include:

the strength of the United States economy in general and the strength of the local economies in which Sterling conducts its operations;

the effects of inflation, interest rate levels and market and monetary fluctuations;

trade, monetary and fiscal policies and laws, including interest rate policies of the federal government;

applicable laws and regulations and legislative or regulatory changes;

the timely development and acceptance of new products and services of Sterling;

the willingness of customers to substitute competitors products and services for Sterling s products and services;

Sterling s success in gaining regulatory approvals, when required;

technological and management changes;

growth and acquisition strategies;

lower-than-expected revenue or cost savings or other issues in connection with mergers and acquisitions;

changes in consumer spending and saving habits; and

Sterling s success at managing the risks involved in the foregoing.

Where You Can Find More Information

The periodic reports Sterling files with the SEC are available on Sterling s website at http://*www.sterlingsavingsbank.com* after the reports are filed with the SEC. The SEC maintains a website located at http://*www.sec.gov* that also contains this information. The information on Sterling s website and the SEC s website is not part of this annual report on Form 10-K. **Sterling will provide you with copies of these reports, without charge, upon request made to:**

Investor Relations

Sterling Financial Corporation

111 North Wall Street

Spokane, Washington 99201

(509) 458-3711

Item 2. Properties

At December 31, 2004, the net book value of Sterling s property (including land and buildings) and its furniture, fixtures and equipment was $78.4 million. Sterling s corporate headquarters is in Spokane, Washington. A summary of Sterling s properties by state as of December 31, 2004 is as follows:

	Action Leased	**INTERVEST Leased**	**Sterling Savings Bank Leased**	**Sterling Savings Bank Owned**	**Total**	**Total Square Footage**
Washington	4	2	26	45	77	565,144
Oregon	4	1	27	49	81	110,385
Idaho	1	0	3	8	12	57,283
Montana	0	0	1	8	9	25,947
Arizona	0					